

REPORT OF EXAMINATION  
OF THE  
EXPLORER INSURANCE COMPANY  
  
AS OF  
DECEMBER 31, 2005

Participating State  
and Zone:

California

Filed December 22, 2006

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Los Angeles, California  
November 29, 2006

Honorable Alfred W. Gross  
Chairman of the NAIC Financial  
Condition (EX4) Subcommittee  
Commissioner of Insurance  
Virginia Bureau of Insurance  
Richmond, Virginia

Honorable Gary L. Smith  
Secretary, Zone IV-Western  
Director of Insurance  
Department of Insurance, State of Idaho  
Boise, Idaho

Honorable John Garamendi  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman, Director and Commissioner:

Pursuant to your instructions, an examination was made of the

#### EXPLORER INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 11455 El Camino Real, San Diego, California 92130.

#### SCOPE OF EXAMINATION

The Arizona Department of Insurance conducted the previous examination of the Company as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

The examination was conducted concurrently with the examination of the Company's parent, Insurance Company of the West.

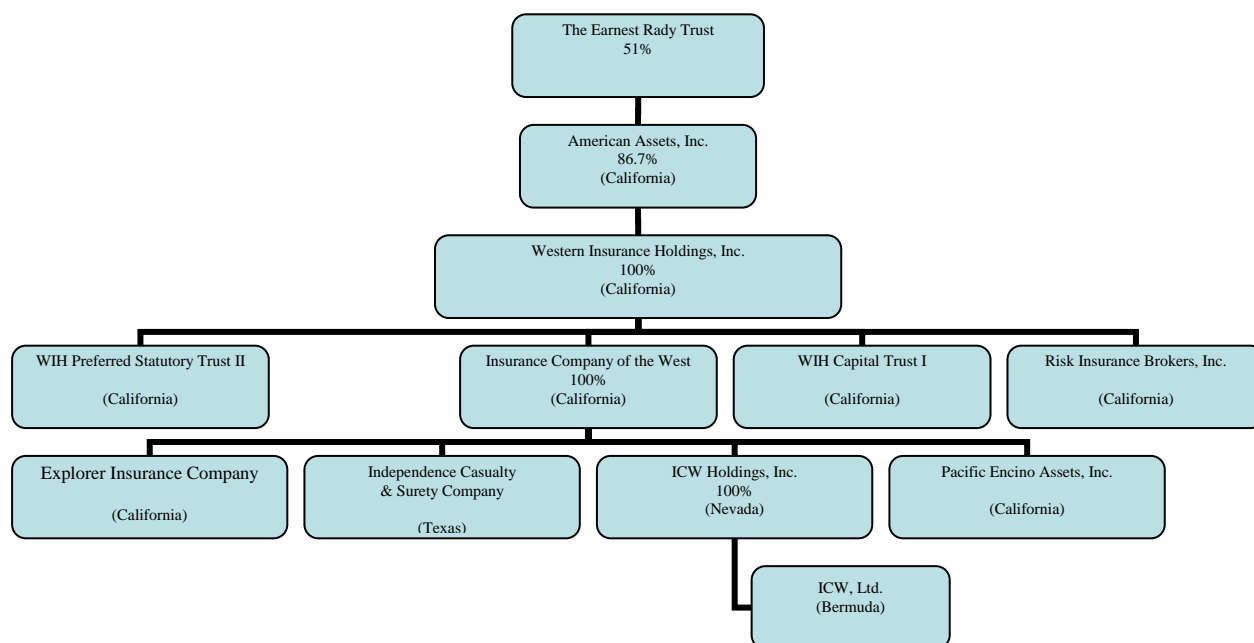
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of the company; business in force by states; loss experience; and sales and advertising.

### COMPANY HISTORY

Effective September 9, 2005, the California Department of Insurance approved the name change of the Company from The Explorer Insurance Company to Explorer Insurance Company and the re-domestication from Arizona to California.

### MANAGEMENT AND CONTROL

Ultimate control of the Company is maintained by Ernest S. Rady and family members. The following organizational chart depicts the Company's relationship within the holding company system:



Management of the Company is vested in a four-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

### Directors

#### Name and Residence

James W. Austin III  
Encinitas, California

Bernard M. Feldman  
Del Mar, California

Ernest S. Rady  
La Jolla, California

#### Principal Business Affiliation

Assistant Secretary  
Insurance Company of the West

Vice Chairman  
Insurance Company of the West

Ultimate Controlling Person  
Insurance Company of the West  
and affiliates

Name and Residence

Frederic B. Tisovic  
Valencia, California

Principal Business Affiliation

Insurance Company of the West

Principal OfficersNameTitle

Kevin M. Prior  
Mary Ellen Cannon  
Henry M. Freet

President  
Secretary  
Treasurer

Management Agreement

Tax Sharing Agreement: The Company and its affiliates are parties to a consolidated federal income tax agreement with the ultimate parent, American Assets, Inc. (AA). Allocation of taxes is based upon separate return calculations with current credit for net losses. Upon review, intercompany tax balances were found to be settled in accordance with the terms of the agreement.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact multiple lines of property and casualty insurance in the following 17 states:

Arizona	Idaho	Nevada	Utah
California	Illinois	New Mexico	Washington
Colorado	Indiana	Oregon	
Florida	Iowa	Pennsylvania	
Hawaii	Montana	Texas	

The Company specializes in nonstandard private passenger automobile liability and physical damage coverages. During 2005, the Company wrote \$105.3 million of direct premiums. Of the direct

premiums written, over 80% pertained to California risks. Business is produced through approximately 1,200 independent agents.

Branch offices are maintained in Fresno, Sacramento, Tustin, and Walnut Creek, California; Albuquerque, New Mexico; Boise, Idaho; Chicago, Illinois; Dallas, Houston, and San Antonio, Texas; Denver, Colorado; Las Vegas, Nevada; Phoenix, Arizona; Portland, Oregon; Salt Lake City, Utah; and Seattle, Washington.

## REINSURANCE

### Intercompany Pooling Agreement

Under the terms of an Intercompany Pooling Agreement, the Company and its affiliate, Independence Casualty and Surety Company (Independence) cede 100 % of written premiums to their parent, Insurance Company of the West (ICW). ICW, in turn, retrocedes a 15 % and 1.5 % pro rata portion of premiums, losses, and expenses to the Company and Independence, respectively.

### Assumed

Assumed business is limited to the Company's participation in the above referenced intercompany pooling agreement.

### Ceded

Ceded business is limited to the Company's participation in the above referenced intercompany pooling agreement.

## ACCOUNTS AND RECORDS

A limited review of the general controls over the Company's electronic data processing activities was conducted. The Company has developed a formal written disaster recovery plan for its electronic data processing, which is currently being updated. Periodic tests, however, have not been performed to ensure its effectiveness. This deficiency was also noted in the previous examination. If a loss of electronic data processing capabilities were to occur, it could be very costly and disruptive to the Company and its policyholders. It is once again recommended that the disaster recovery plan be tested at the earliest possible time.

In addressing the need for an effective disaster recovery plan, the Company engaged SunGard Availability Services (SunGard) to conduct a Business Impact and Strategy Analysis for twenty-five of its key business units during the months of January 2006 to April 2006. The Company is currently assessing SunGard's recommendations regarding the implementation, maintenance and testing of such a recovery plan. The Company expects to complete its assessment later in 2006, with implementation taking place in 2007.

The Company has also hired a business resiliency manager to design, implement and maintain a comprehensive disaster recovery plan.



## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2001 through December 31, 2005

Statement of Financial Condition  
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 46,888,270	\$	\$ 46,888,270	
Preferred stocks	306,600		306,600	
Common stocks	21,516,039		21,516,039	
Cash and short-term investments	(1,051,623)		(1,051,623)	
Investment income due and accrued	506,813		506,813	
Uncollected premiums and agents' balance in the course of collection	4,959,082	465,000	4,494,082	
Deferred premiums, agents balances and installments booked but deferred and not yet due	26,861,863		26,861,863	
Amounts recoverable from reinsurers	(363,161)		(363,161)	
Guaranty funds receivable or on deposit	671,636		671,636	
Receivable from parent, subsidiaries and affiliates	2,082,350		2,082,350	
Aggregate write-ins for other than invested assets	<u>467,371</u>	<u>                    </u>	<u>467,371</u>	
Total assets	<u>\$102,845,240</u>	<u>\$ 465,000</u>	<u>\$102,380,240</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 26,368,995	(1)
Loss adjustment expenses			7,284,450	(1)
Commissions payable, contingent commissions and other similar charges			216,164	
Other expenses			98,269	
Taxes, licenses and fees			136,621	
Current federal and foreign income taxes			710,712	
Net deferred tax liability			93,834	
Unearned premiums			13,220,362	
Ceded reinsurance premiums payable			23,639,446	
Amounts withheld or retained by company for account of others			427,500	
Payable for securities			48,780	
Aggregate write-ins for liabilities			<u>1,686,839</u>	
Total liabilities			73,931,972	
Common capital stock		\$ 2,600,000		
Gross paid-in and contributed surplus		8,070,835		
Unassigned funds (surplus)		<u>17,777,433</u>		
Surplus as regards policyholders			<u>28,448,268</u>	
Total liabilities, surplus and other funds			<u>\$102,380,240</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Premiums earned		\$ 35,933,709
Deductions:		
Losses incurred	\$ 16,134,708	
Loss expense incurred	5,539,520	
Other underwriting expenses incurred	<u>12,124,269</u>	
Total underwriting deductions		<u>33,798,497</u>
Net underwriting gain		2,135,212

Investment Income

Net investment income earned	\$ 2,883,411	
Net realized capital losses	<u>(121,955)</u>	
Net investment gain		2,761,456

Other Income

Net loss from agents' or premium balances charged off	\$ (1,457,396)	
Finance and service charges not included in premiums	461,552	
Aggregate write-ins for miscellaneous income	<u>1,402,092</u>	
Total other income		<u>406,248</u>
Net income before dividends to policyholders and before federal income taxes		5,302,916
Dividends to policyholders		119,116
Federal and foreign income taxes incurred		<u>2,274,803</u>
Net income		<u>\$ 2,908,997</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$25,521,856
Net income	\$ 2,908,997	
Change in net unrealized capital gains	1,416,295	
Change in net deferred income tax	404,676	
Change in nonadmitted assets	367,148	
Aggregate write-ins for losses in surplus	<u>(2,170,704)</u>	
Change in surplus as regards policyholders		<u>2,926,412</u>
Surplus as regards policyholders, December 31, 2005		<u>\$28,448,268</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2001 through December 31, 2005

Surplus as regards policyholders, December 31, 2001, per Examination (*)			\$15,775,478
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$10,896,794	\$	
Change in net unrealized capital gains	4,236,270		
Change in net deferred income tax	619,778		
Change in nonadmitted assets	77,643		
Aggregate write-ins for losses in surplus	<u>                    </u>	<u>3,157,695</u>	
Totals	<u>\$15,830,485</u>	<u>\$ 3,157,695</u>	
Net increase in surplus as regards policyholders			<u>12,672,790</u>
Surplus as regards policyholders, December 31, 2005, per Examination			<u>\$28,448,268</u>

(\*) Examination completed by the Arizona Department of Insurance

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses as of December 31, 2005 were found to be reasonably stated.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Accounts and Records (Page 6): It is recommended that the disaster recovery plan be tested at the earliest possible time. This deficiency was also noted in the previous examination. . In response to this recommendation, the Company is currently assessing its outside consultant's recommendations regarding the implementation, maintenance and testing of its disaster recovery plan. The Company expects to complete its assessment later in 2006, with implementation taking place in 2007.

### Previous Report of Examination

None.

## ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

\_\_\_\_\_/S/\_\_\_\_\_  
David A. Fischman, CFE  
Examiner-In-Charge  
Senior Insurance Examiner  
Department of Insurance  
State of California